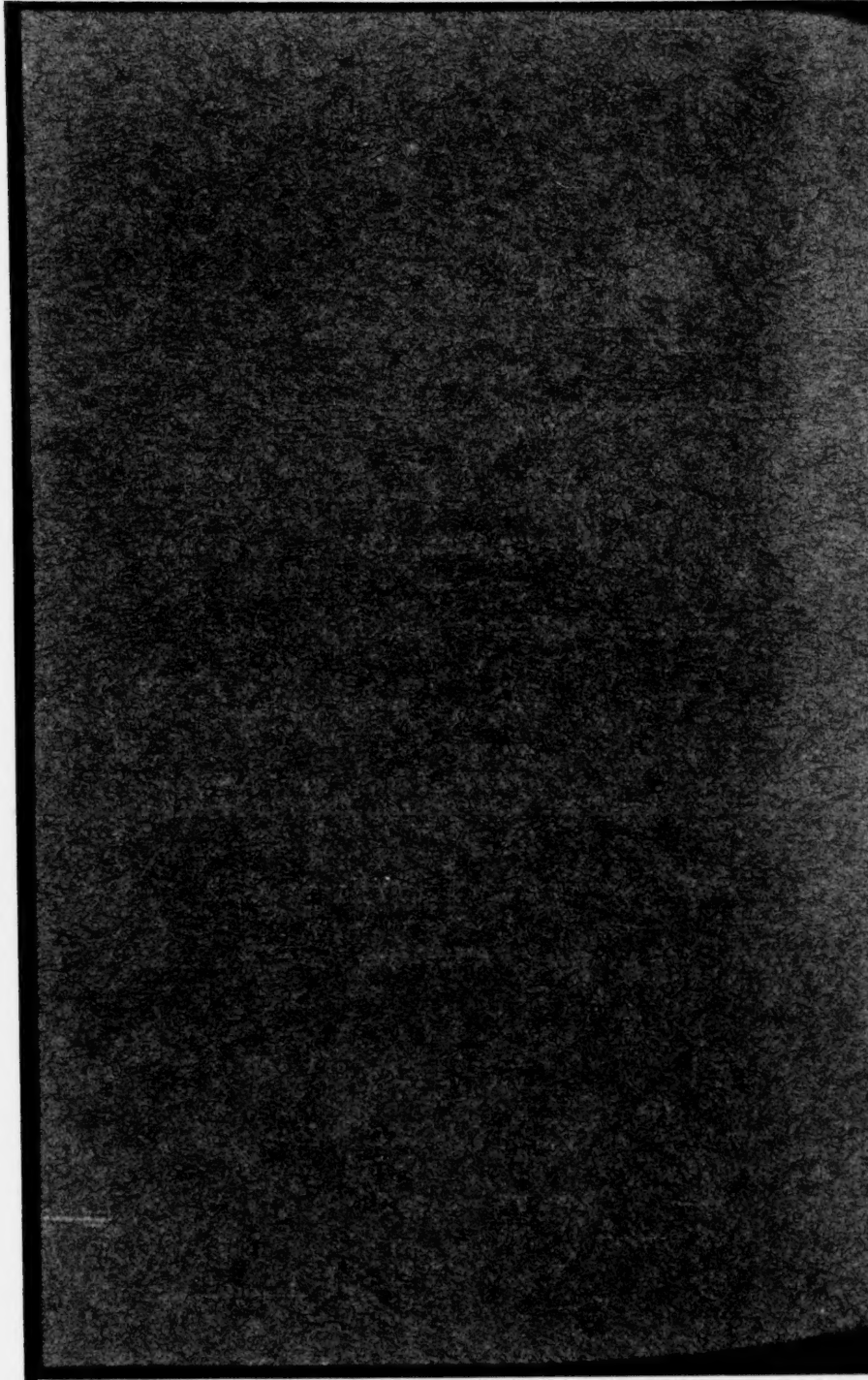

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CITATIONS

606273—44

In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 317

J. STERLING ROCKEFELLER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The Tax Court entered memorandum findings of fact and an opinion which are not reported but appear at R. 30–37. The opinion of the Circuit Court of Appeals (R. 185–187) is reported at 142 F (2d) 354.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 6, 1944 (R. 192). The petition for a writ of certiorari was filed August 3, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Tax Court and the Circuit Court of Appeals for the Second Circuit have erred in determining that certain secured debentures issued by Garrison Fire Detecting System, Inc., a Delaware corporation, were not ascertained by the taxpayer to be worthless in 1937, the tax year for which the taxpayer claims a bad debt deduction under Section 23 (k) of the Revenue Act of 1936.

STATUTE INVOLVED

The applicable statute is Section 23 (k) of the Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (k) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year * * *
>
> * * * * *

STATEMENT

The facts as found by the Tax Court (R. 30–35) may be summarized as follows:

Early in 1931 the taxpayer purchased $74,000 face amount of debentures of the Garrison Fire Detecting System, Inc., a Delaware corporation, at a cost of $74,000. The corporation, organized in 1925 for the development, manufacture, and sale of automatic fire detection and fire extinguishing devices, had not been successful, but had suffered

substantial deficits. The debentures in question were of a total issue of $125,000 of 6% secured debentures issued in 1931 to mature in ten years. They were secured under an agreement with Empire Trust Company, a New York corporation, by letters patent then held or which might subsequently be acquired by the Delaware corporation. The Delaware corporation transferred the letters patent as security but continued to hold the right to operate and license others to operate under them. (R. 30–31.)

Continuing unsuccessful and with an increased deficit, the Delaware corporation in 1932 granted an exclusive right to operate under the patents to Garrison Fire Detecting System, Inc., a New York corporation. The taxpayer invested over $26,000 in stock of Garrison of New York in 1932 and 1933. (R. 31.) In October, 1933, another company, Garrison Engineering Corporation, was incorporated under New York law to operate under a license from the Delaware corporation and the taxpayer advanced funds for this company (R. 32).

The Delaware corporation enjoyed but little better success after the granting of the license agreements than it had before, and sustained substantial operating losses in 1933, 1934, and 1935. In 1935 a third corporation, Garrison Engineering Corporation, was organized under Massachusetts law to operate under a license from the Delaware corporation. From October 27, 1935, to January 14,

1936, the taxpayer invested $45,000 in its stock, and from January, 1936, to July, 1936, he loaned the company upwards of $25,000. (R. 32–33.)

Each of the licensee companies was obligated to make royalty payments to the Delaware corporation, some part of which was to be used to satisfy the Delaware corporation's obligations under the debenture agreement (R. 32, 33). After the early part of 1934 the Delaware corporation received no royalty payments from any of its licensees. The Massachusetts corporation was liquidated in 1938 because of disagreement concerning its management. It was the last of the corporations to operate under license from the Delaware corporation. In his income tax return for 1936 the taxpayer deducted from gross income $45,000, representing his investment in stock of the Massachusetts corporation, as having become worthless in 1936. (R. 33.)

In February, 1933, the taxpayer purchased an additional $1,000 of the debentures of the Delaware corporation at a cost to him of $400. In January, 1935, he assumed and paid its indebtedness of $2,500, in consideration of the company's agreement to issue to him a further $3,000 face amount of its debentures. These last debentures were never issued. (R. 32.)

On May 4, 1936, the Delaware corporation caused to be filed its petition for reorganization under Section 77B of the Bankruptcy Act. In

Schedule A, attached to the petition, the assets, consisting solely of its patents, patent rights and good will, were valued at $255,972.89. Describing the financial condition of the corporation the petition stated: "No cash or securities of any nature in possession; there is outstanding a contract with Garrison Engineering Corporation (Mass.) the value of which is uncertain." On September 17, 1936, the taxpayer filed answer and objections to the petition for reorganization in which he asserted that the assets listed in the petition were "grossly over valued," that the debtor was "hopelessly insolvent," and requested reference to a special master to determine the question of solvency. On November 6, 1936, the vice-president and secretary of the Delaware corporation filed an affidavit and a certified copy of a resolution of the board of directors adopted on November 2, 1936. The general purport of the two documents was that the board had concluded that the assets of the corporation had been given an excessive valuation in the petition; that upon consideration it had determined that their fair market value was not more than $10,000; and that it would be to the best interest of the corporation to be liquidated and dissolved. On November 6, 1936, the court, reciting the taxpayer's consent, ordered that the corporation be liquidated. Subsequently, the taxpayer filed proof of claim of an aggregate sum of $106,351.80, representing the face amount

of the debentures issued to him and of those not issued but to which he was entitled, and unpaid interest thereon. (R. 33–34.)

On April 15, 1937, the bankruptcy referee offered the patents and patent applications for sale. The representative of some of the debenture holders, of whom the taxpayer was one, was the sole bidder. Acceptance of his offer of $100 being recommended by the bankruptcy trustee, the referee ordered sale and the same was consummated on April 17, 1937. The proceeds were insufficient to pay the expenses of the proceedings. (R. 35.)

At some time subsequent to the bankruptcy sale, the taxpayer was advised by his attorney that the debentures should be treated as having become worthless in 1937, and that deduction of their cost should be made from his gross income for that year. On December 31, 1937, at the taxpayer's direction his confidential bookkeeper and accountant set up an account for the debentures and made the appropriate entries charging them off as worthless. (R. 35.)

No interest on the debentures was ever paid to the taxpayer, although scrip in lieu of some of the interest payments had been issued to and received by him (R. 35).

The taxpayer reported his gross income for 1936 as $103,477.89, against which he claimed deductions aggregating $53,322.03. His 1937 return showed gross income of $116,684.58. Total deduc-

tions were claimed in the sum of $87,592.12, of which $76,900 was the cost of the debentures, the charge-off of which is here in issue. (R. 35.)

The Tax Court concluded that the taxpayer had failed to show that he ascertained the debentures to be worthless in 1937 (R. 36–37). The Circuit Court of Appeals, *per curiam*, affirmed the Tax Court's decision (R. 185–187).

ARGUMENT

The decision below is squarely ruled by the prior circuit court of appeals decisions which the taxpayer asserts to be conflicting. (Br. 5–6.) To be entitled to a deduction the taxpayer must prove that he ascertained in the tax year that the debt was worthless. As the cases cited by the taxpayer hold, he may validly have ascertained the debt to be worthless in the tax year even though the debt in fact had become worthless in an earlier year, and even though a "reasonably prudent person" would have so ascertained. But if the debt was not in fact worthless in the tax year, the taxpayer could not have ascertained its worthlessness in the tax year. Accordingly, to sustain his deduction he must prove both that the debt was in fact worthless in the tax year and that he then so ascertained. *San Joaquin Brick Co.* v. *Commissioner*, 130 F. (2d) 220 (C. C. A. 9); *Rosenthal* v. *Helvering*, 124 F. (2d) 474 (C. C. A. 2); *Mayer Tank Mfg. Co.* v. *Commissioner*, 126 F. (2d) 588

(C. C. A. 2); *Harris* v. *Commissioner*, 140 F. (2d) 809 (C. C. A. 2).

There is no indication in the opinion of the Circuit Court of Appeals that it discarded the so-called subjective test as defined in those decisions and substituted an objective test, i. e., a test as to when a reasonably prudent man would have ascertained the debentures to be worthless. The Circuit Court of Appeals affirmed the decision of the Tax Court that the taxpayer failed to prove his ascertainment in 1937 that the debentures were worthless (R. 186–187). The taxpayer relied primarily on the fact that the patents securing the debentures were sold on April 17, 1937, for $100. However, there was no showing that there had been any change in their value since 1936. The Tax Court concluded that the debentures were in fact worthless in 1936, and that the taxpayer was not shown to have thought them to have any value after 1936 (R. 36–37). Moreover, the sale of the patents for $100 was not free and clear, but subject to the lien of the debentures which, so far as the record shows, remained outstanding. Hence, without impugning the correctness of the Tax Court's reasoning the Circuit Court of Appeals held that the taxpayer could not prevail even upon his version of the facts as urged in that court. Accepting the taxpayer's premise that the debentures had some remnant of worth at the beginning of the tax year which justified

his continued hope of salvage, the record fails to show that this worth was extinct when the tax year closed. The sale subject to the lien did not demonstrate its extinction. At the time of the hearing in 1942 the company which bought the patents subject to the lien was still selling the same products formerly made under the patents, and sales of apparatus went on through 1937 (R. 57–58). Thus the taxpayer has failed to prove either that the debentures were worthless in fact or that he ascertained their worthlessness in the tax year.

The decision below correctly affirmed the decision of the Tax Court upon a question which is wholly one of fact. Moreover, any question relating to the ascertainment of worthlessness of a debt is rendered unimportant by Section 124 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798 (26 U. S. C. 1940 ed., Supp. III, Sec. 23 (k)). Section 124 (a) amends Section 23 (k) of the Internal Revenue Code to provide retroactively to all years beginning after December 31, 1938, that there shall be allowed as a deduction "Debts which become worthless within the taxable year".

The second point urged by the taxpayer (Br. 7) relates to the Tax Court's exclusion of evidence purporting to show that the Commissioner allowed a bad debt deduction in 1937 to another holder of the debentures (R. 65–66). The evidence was properly excluded as irrelevant (cf. *Seeley* v. *Helvering*, 77 F. (2d) 323 (C. C. A. 2)), and its exclusion plainly raises no question for certiorari.

CONCLUSION

The petition should be denied.

Respectfully submitted.

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Argument.

The respondent Commissioner's brief in opposition clearly demonstrates the weakness of his position.

The Commissioner has never made a finding that the Debentures became or were worthless in 1936 or that the taxpayer ascertained them to be worthless in 1936. All the Commissioner originally determined was that no deduction was allowable for the taxable year 1937 on account of the worthlessness of the Debentures (R. 11).

The Tax Court in its opinion, however, decided that it was the taxpayer's burden to show erroneous the Commissioner's nonexistent determination that the taxpayer ascertained the worthlessness in 1936 and further the Tax Court decided that the Debentures were worthless in 1936 (R. 37).

The Circuit Court of Appeals held this part of the decision to be *dicta* (R. 188).

The Circuit Court further decided that the Debentures had not become worthless in 1936 and likewise decided that the taxpayer had not ascertained them to be worthless in 1936 (R. 187).

The whole issue as stated by the Circuit Court is whether or not there was competent evidence to show that the worthlessness of the debt was made certain in 1937 (R. 186).

The meaning of "ascertainment" is discussed in *Quinn* v. *Commissioner*, 111 F. (2d) 372 (C. C. A. 5), where in connection with the deductibility of bad debts it is stated at page 373:

> "The word ascertain means to make certain; to find out or learn for a certainty; to free from obscurity or doubt. Hence, to justify a deduction, the taxpayer must have made a reasonable investigation of the facts and have drawn a reasonable inference that the debt was in fact worthless from the information thus obtained."

On that question, the only evidence in the record is: (1) The petition in bankruptcy (R. 146-7) containing a balance sheet as of April 30, 1936, showing assets of about $255,000 and liabilities of some $177,000, which does not indicate worthlessness; (2) the Answer of this taxpayer, filed September 14, 1936, under oath, stating that he believed the above valuation was grossly excessive and that the debtor was hopelessly insolvent, which however did not determine the worthlessness as the Circuit Court held (R. 186), particularly as in the Answer, this taxpayer (R. 172) asserted that he had unsuccessfully tried to obtain access to the corporate books and records to ascertain whether the bal-

ance sheet of the debtor, attached to the petition in bankruptcy, was correct, and that suggested that he, at least, had not then (September 14, 1936) been able to make certain of the worthlessness; (3) the order of the Court, September 16, 1936 (R. 153) referring the matter to a special Master to hear evidence to determine whether the debtor is insolvent, was not an ascertainment, since that order was vacated in November, 1936 (R. 154); (4) the affidavit of Kaul (R. 176) stating that the value of the assets did not exceed $10,000 and that the liabilities were $177,000, if assumed to be competent, was not such an ascertainment at that time (November 2, 1936) since, except for the sum of about $3,700, the liabilities were all to the debenture holders of which this taxpayer had a 3/5 interest so that his proportionate share of the assets would amount to some $3,800; (5) the petition for sale of the assets (R. 159), their value "*being unknown*", filed April 2, 1937, did not make certain of their worthlessness; (6) and finally on April 17, 1937, the assets were sold for an amount insufficient to pay the expenses of the proceeding (R. 35) and it was then for the first time made *certain* that the debt was worthless.

There is no evidence whatever that in 1936 anybody had made certain of the worthlessness. It is obvious from the evidence that no one could have ascertained the debt to be worthless before April 15, 1937. The value of the patents were absolutely unknown until then. Worthlessness of a debt must be distinguished from insolvency of the debtor which does not mean any more than his liabilities exceed his assets so that the creditors must take something less than 100% of his debt. To be worthless there must be no assets or substantially none and this must be made *certain*. Accordingly if, under the evidence in this case, the tax-

payer had charged off the debt in 1936 and claimed it to be then worthless, and it developed, as it has done here, that worthlessness was not made certain until April, 1937, the taxpayer could not then switch to 1937 because he had already charged off the debt in 1936 and could not charge it off again. The statute required that the charge off be made during the same year that it is made certain that the debt is worthless. This taxpayer, therefore, did the only safe thing, that is, he waited until it was made certain that the debt was worthless.

The suggestion of the Court that he may have had some motive for postponing the ascertainment lacks merit. One cannot possibly make certain of a thing before it becomes certain. In addition the taxpayer would not have been without benefit in claiming the loss in 1936 since the deduction he did take then still left some $53,000 of net income which he could have wiped out if he dared take the chance of having the Commissioner and/or the Court finally determine that worthlessness was not made certain until 1937.

On the other hand, it has been proved without contradiction that in 1937 after said sale the taxpayer consulted with his attorney who advised that the Debentures should be treated as having become worthless in 1937 and that their cost should be deducted from taxpayer's 1937 gross income. In 1937 the taxpayer's bookkeeper, upon taxpayer's instructions, made the appropriate entries so charging them off as worthless (R. 35).

The taxpayer's testimony is likewise uncontradicted that he ascertained the Debentures to be worthless in 1937 after the sale of the patent interests was completed (R. 53).

Even if the patent interests may still have had some value throughout 1937, it does not follow that the Debentures did not therefore become valueless in 1937. This

is not a case of partial deduction (R. 187) but one where the debtor Delaware corporation lost in 1937 all its right, title and interest in its sole remaining assets by the 1937 bankruptcy sale. The Delaware corporation then became lifeless and its obligations, including the Debentures, at the same time became wholly worthless. If the taxpayer in the future should ever realize anything by virtue of the so-called lien of the Debentures, such amount would presumably be includible in his gross taxable income.

That taxing laws are to be construed strongly against the government and in favor of the taxpayer is axiomatic. *Gould* v. *Gould*, 245 U. S. 151, 153.

The Commissioner's statement (Br. 9) that the amendment provided by the 1942 Revenue Act renders unimportant any question relating to ascertainment of worthlessness is not persuasive. The petition herein involves a tax liability of $32,733.96 (R. 30). In addition the 1942 amendment was itself further amended by Section 504 of the Revenue Act of 1943 to apply to all taxable years beginning after December 31, 1937. Accordingly the question of when ascertainment occurred is still of considerable importance as to all years prior to 1938.

The 1942 and 1943 amendments therefore are not a clarification of an old purpose but are a declaration of a new one, leaving the old purpose still in doubt, so much so that the 1943 amendment was deemed necessary for all future years after 1937.

It was never the purpose of Congress either to deny such a deduction or to require a taxpayer to guess when to take it. The above amendments eliminating the charge off and the doubtful word "ascertained" substantiates this.

Conclusion.

The petition should be granted.

Respectfully submitted,

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